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IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

STANLEY M. GROSSMAN,

Petitioner,

v.

FIDELITY MUNICIPAL BOND FUND, INC. and
FIDELITY MANAGEMENT AND RESEARCH CO.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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Question Presented

Is demand upon the directors of an investment company a prerequisite to the commencement of a security-holder's action for excessive compensation under § 36(b) of the Investment Company Act?

Parties to the Proceedings

Petitioner is the plaintiff and appellant below. In addition to the respondents the defendants-appellees were Edward C. Johnson III, William M. Byrnes, Caleb Loring, Jr., Dwight L. Allison, Jr., Eugene H. Clapp II, Robert L. Johnson, George McKenzie, William R. Spaulding and FMR Corp. In addition, the Securities and Exchange Commission appeared in the Court of Appeals as *amicus curiae*.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Decisions Below

The decision of the district court is reported at 89 F.R.D. 656; the decision of the Court of Appeals is reported at 674 F.2d 115.

Jurisdiction

The judgment of the Court of Appeals for the First Circuit is dated and was entered on March 29, 1982. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

Statutes Involved

This case involves the interpretation of § 36(b) of the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-35(b), and Rule 23.1 of the Federal Rules of Civil Procedure. Both provisions are set forth in the Appendix.

Statement of the Case

Plaintiff brings this action as a shareholder of Fidelity Municipal Bond Fund, Inc. (the "Fund"), an investment company investing in municipal bonds. Defendant Fidelity Management and Research Co. ("FMR") is the Fund's investment adviser. The additional defendants, not named as respondents herein, are the Fund's directors and FMR's parent.

The complaint contains two principal charges, of which only one is the subject of this petition. That contention is that FMR has exacted from the Fund excessive compensation in violation of the fiduciary duty imposed upon it by § 36(b) of the Investment Company Act as amended, 15 U.S.C. § 80a-35(b).

After the Fund began offering its shares to the public in the late 1970's, its assets soared, in 2½ years, from $540,000 to approximately $600,000,000. The Fund's original advisory and service contract provided for a management fee payable to FMR at an annual rate of .4% of the average daily net assets of the Fund. In spite of the tremendous increase in the asset size of the Fund, the management fee percentage has remained unchanged so that, as of the filing of the amended complaint, the Fund was incurring obligations to FMR at a rate of approximately $2,400,000 per year.

Failure to reduce the management fee as the size of the Fund increased was highly unfair to the Fund and its shareholders, since the tremendous rise in the management fee was vastly disproportionate to any increase in the expenses of FMR.* Thus, in 1977, 1978 and 1979, FMR's profit ratio resulting from operating the Fund exceeded 60% and profits totalled well over $5,000,000.

Jurisdiction is based upon § 36(b) and upon § 44 of the Act, 15 U.S.C. §§ 80a-35 and 80a-43. Section 36(b) provides, in relevant part, that investment advisers have a fiduciary duty with respect to the receipt of compensation from an investment company such as the Fund. That section specifically states that an investment company shareholder may bring suit on behalf of the investment company for breach of fiduciary duty with regard to compensation paid to the adviser.

In light of the express authorization of shareholder suits in Section 36(b), plaintiff did not make a demand upon the directors of the Fund prior to bringing suit. As shown below, imposition of a demand requirement conflicts with prior rulings of this Court, and also conflicts with the purpose of Section 36(b) to provide shareholders with an effective remedy for breach of fiduciary duty by the adviser.

Prior to answering, defendants moved to dismiss the complaint for plaintiff's failure to make a demand upon the board of directors. At the district court's invitation, plaintiff made a post-complaint demand. Thereupon, the Fund's

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* The Fund's assets are invested in municipal bonds and not in a diversified range of industrial securities. Therefore, FMR's services are substantially routine and do not require numerous highly paid securities analysts and portfolio managers. As contrasted to the .4% charged by FMR to the Fund, other municipal bond funds with independent boards of directors have retained highly qualified investment advisers for as little as .15% annually.

directors formed a special committee of two who hired an outside counsel to investigate and report to them. Counsel recommended that the directors seek to dismiss the complaint and, shortly thereafter, the special committee voted to do so, thus rejecting plaintiff's post-complaint demand.

Defendants then moved to dismiss or, alternatively, for summary judgment. The district court granted both motions in the alternative, holding that a pre-complaint demand was required and was not satisfactorily made, and that, in any event, the action was properly terminated by the special committee of directors. The Court of Appeals affirmed the demand ruling, finding it unnecessary to reach the legitimacy of the termination.

Reasons for Granting the Writ

A. *The Court of Appeals decided an important question of federal law in conflict with applicable decisions of this Court.*

The decision of the Court of Appeals involves an important question of federal law. Over $240 billion are currently invested in the securities of investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940.* As recognized in the Senate report on the amendment which gave rise to section 36(b), mutual fund companies constitute "an investment medium of major significance". S.Rep. No. 91-184, 91st Cong. 1st Sess., p.3 (1969). That legislation was designed to "update our Nation's securities laws so that they will be better suited for an ever-expanding investment company industry." *Id.* at p. 2.

The legislation which gave rise to section 36(b) resulted from an express determination by Congress that

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* N.Y. Times, April 29, 1962, Section D (Business) at 12, col. 4.

conflicts of interest on the part of mutual fund directors rendered it necessary to strengthen the right of mutual fund shareholders to challenge breaches of fiduciary duty involving excessive compensation. The need for effective shareholder enforcement resulted from the fact that "the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary standards in considering questions concerning management fees." *Ibid.* As described in the House Report:

> "The relationship between the investment company and its investment adviser results in a structure which is different from the conventional bargaining relationship between buyer and seller. Since the typical mutual fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on those services, a mutual fund cannot, as a practical matter, sever its relationship with the adviser. Therefore, the forces of arms-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."

H. Rep. No. 91-1382, 91st Cong. 2d Sess. (1970), p. 7.

In consequence, Congress determined that mutual fund shareholders should have an "effective" mechanism for challenging breaches of fiduciary duty by mutual fund advisers in the courts. As stated in the Senate report,

> "Therefore your committee has adopted the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the courts to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty. This bill would make it clear that, as a matter of Federal law, the investment

> adviser or mutual fund management company has a fiduciary duty with respect to mutual fund shareholders. It provides an effective method whereby the courts can determine whether there has been a breach of this duty by the adviser or by certain other persons with respect to their compensation from the fund. Senate report, *supra*, at p. 2.

As recognized by Judge Friendly, Congress was dissatisfied with the ineffectiveness of investment company directors, and "significantly amended" the Act to add § 36(b) "to afford an express private remedy" to shareholders and the SEC for excessive advisory fees charged by investment advisers to investment companies; *Fogel* v. *Chestnutt*, 668 F.2d 100, 111, 112 (2d Cir. 1981).

Imposition of a demand requirement significantly undercuts the Congressional purpose of granting shareholders an effective means of obtaining court review of breaches of fiduciary duty with respect to compensation. At least 22 cases brought by security holders of such investment companies are presently pending.* In many of these the defense with respect to demand upon directors has been made. While the lower court cases have followed divergent paths,** failure to make a pre-complaint demand has

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* Frankel, "Money Market Funds," 14 *The Review of Securities Regulation* 913, 921-24 (May 10, 1981).

** In the Southern District of New York alone at least four different approaches have been taken to the question of demand in an action brought under § 36(b). In *Boyko* v. *The Reserve Fund*, 68 F.R.D. 692 (S.D.N.Y. 1975, Gagliardi, J.), the court held that as long as one director was affiliated with the investment adviser, demand was excused. In *Blatt* v. *Dean Witter*, 528 F. Supp. 1152, 1155 (S.D.N.Y. 1982, Lasker, J.) and *Markowitz* v. *MoneyMart Assets*, CCH Fed. Sec.L.Rep. ¶ 98,360, pp. 92, 211-12 (S.D.N.Y. 1981, Carter, J.), the courts stated in *dicta* that under the statute no demand is required. In *Markowitz* v. *Brody*, 90 F.R.D. 542 (S.D.N.Y. 1981, Ward, J.), the court held that demand is required

resulted in dismissal of the action in a number of instances.* Since the dismissal for lack of a demand precludes the court from making its own determination with respect to whether a breach of fiduciary duty has occurred, the Court of Appeals decision significantly obstructs congressional intent and the enforcement of legislative policy.

In deciding this important question of federal law the Court of Appeals resolved the issue in a way which conflicts with applicable decisions of this Court in two respects. First, the Court of Appeals ignored this Court's determination that board action may not cut off derivative suits brought under § 36(b) of the Act. Second, the decision below that the Fund has an implied right of action under Section 36(b) which may be enforced by the Fund's directors conflicts with the standards which this Court has enunciated with respect to implying rights of action under Federal statutes.

(1) In *Burks* v. *Lasker*, 441 U.S. 471 (1979), this Court considered the Congressional intention in enacting § 36(b) and held that under that section a security holder's action may not be terminated by a court simply because the board of directors or a committee thereof urge it to do so:

> "And when Congress did intend to prevent board action from cutting off derivative suits it said so expressly. Section 36(b), 15 U.S.C. §80a-35(b)(2) added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty

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but that the plaintiff would be given leave to make a post-complaint demand and submit an amended complaint to that effect. In *Fox* v. *Reich & Tang*, CCH Fed.Sec.L.Rep. ¶ 98,612 (S.D.N.Y. 1982, Duffy, J.), the court held that failure to make a pre-complaint demand required dismissal of the complaint without leave to amend.

* *E.g.*, the case at bar, and *Fox* v. *Reich & Tang*, *supra*.

with respect to adviser's fees." *Id.* at 484. (footnote omitted)

The court below acknowledged that *Burks* v. *Lasker* prevented directorial termination of an action brought under §36(b) (27a-28a). However, said the court, this does not mean that demand is excused (28a). The demand requirement of Rule 23.1 is still useful, it said, because it gives the directors an opportunity to express their views (Ibid.).

However, there is no logical justification for treating termination of an action differently than the demand requirement. When this Court said that Congress intended "to prevent board action from cutting off derivative suits", it based its holding on a statute which simply provides that a security holder can bring an action. The statute itself refers neither to demand nor to termination. However, the strong implication of the statute and its legislative history is that Congress intended to permit plaintiff shareholders to by-pass the board of directors because mutual fund directors could not be trusted to make an objective decision concerning compensation.

The purpose of a demand is to enable the board of directors to exercise their business judgment. Where, as here, Congress has concluded that directorial judgment is not determinative, a demand is not required. The Court of Appeals' conclusion that a shareholder must await the outcome of the directors' deliberations is in direct conflict with Congress' findings that "the unaffiliated directors have not been in a position to secure changes in the level of advisory fees rates" * so that the "responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court".**

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* H. Rep. No. 2337, 89th Cong. 2d Sess., p. 131 (1966).

** S. Rep. No. 91-184, 91st Cong. 1st Sess., p. 6 (1969).

(2) The courts below improperly imposed a demand requirement despite the absence of any Congressional intent to create a right of action on the part of the Fund under Section 36(b) which is enforceable by the directors. In doing so, they implied a right of action in contravention of standards which have been repeatedly enunciated by this Court.

In *Blatt* v. *Dean Witter Reynolds Intercapital, Inc.*, 528 F.Supp. 1152 (S.D.N.Y. 1982), the court recognized that it would be inappropriate to require a demand in actions under 36(b) because the directors are not empowered to take the very action which would be demanded. Judge Lasker stated:

> "Indeed, §36(b) does not expressly authorize the investment company to bring suit; '[i]t thus appears that in enacting Section 36(b) Congress assumed that the directors of an investment company would be antagonistic toward, and unlikely to prosecute, an action against the Fund's advisers . . .' *Boyko* v. *Reserve Fund, Inc.*, 68 F.R.D. 692, 694 (S.D.N.Y. 1975). Since the directors cannot prevent plaintiffs' suit nor does the statute provide directors the right to institute suit, the basis of the demand requirement in the ordinary derivative action, that 'the complaining plaintiff should not be able to attempt to control corporate management without first requesting appropriate action by the directors . . .', 3B Moore's Federal Practice ¶23.1.14[4], p. 23.1.39, does not appear to apply logically in the context of a §36(b) suit." 528 F.Supp. at 1155.

The decision below that a right of action on the part of the Fund should be implied runs counter to the standard applied by this Court in determining whether or not a private right of action may be implied under a federal

statute. This Court has repeatedly refused to imply a private right of action when the statutory scheme and legislative history show that the provision involved was not designed to facilitate the type of suit at issue.* As described above, Section 36(b) was clearly not designed to enable the Fund directors to bring a breach of fiduciary duty suit by the Fund, since the basic motivation for that provision was a recognition that the directors of a mutual fund could not be trusted to make an objective decision concerning fairness of compensation.

As recognized in *Boyko* v. *The Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y. 1975), ". . . nowhere in the legislative history of Section 36(b) does an action by the directors of the Fund seem to be contemplated." *Id.* at 695. In that connection, the court stated:

> "This omission was apparently not the result of Congressional oversight. The legislative history of the amendments is relatively comprehensive, and the amendments themselves were enacted in the Senate only after a three-year period of extensive committee hearings and executive sessions on the subject matter. 1970 U.S. Code Cong. & Admin. News. p. 4897. Moreover, although Congress did not give the fund directors an express procedural role to play in a Section 36(b) action, the legislative history is not silent on the function of the fund directors in this area:

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* *E.g.*, *Middlesex County Sewerage Authority* v. *National Sea Clammers Association*, 453 U.S. 1 (1981), cited approvingly by both the majority and the dissent in *Merrill Lynch, etc.* v. *Curran*, No. 80-203, slip op. p. 24; dissent, pp. 2, 4, 12 (U.S. Sup. Ct., May 3, 1982); *Touche Ross* v. *Redington*, 442 U.S. 560 (1979); *Cannon* v. *University of Chicago*, 441 U.S. 677 (1979); *Transamerica Mortgage Advisors* v. *Lewis*, 444 U.S. 11 (1979); *Universities Research Association* v. *Coutu*, 450 U.S. 754 (1981); *Northwest Airlines* v. *Transport Workers Union*, 451 U.S. 77 (1981); *California* v. *Sierra Club*, 451 U.S. 287 (1981); *Texas Industries* v. *Radcliff Materials*, 451 U.S. 630 (1981).

> 'Directors of the fund, including the independent directors, have an important role in the management fee area. A responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored. While the ultimate responsibility for the decision in determining whether the fiduciary duty has been breached rests with the court, approval of the management fee by the directors and shareholder ratification is to be given such weight as the court deems appropriate in the circumstances of a particular case.'
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> 1970 U.S. Code Cong. & Admin. News, p. 4903." *Id.* at 695-96, n.2.

Nor are the Fund directors in a position to have the Fund bring an action for breach of fiduciary duty under applicable state law, since actions under Section 36(b) are the exclusive remedy for breach of fiduciary duty with respect to excessive compensation. Thus in *Fogel* v. *Chestnutt*, 668 F.2d 100 (2d Cir. 1981), the court stated (p. 112):

> "We might agree with defendants that Section 36(b) with the severe limitations of subsection (3), constitutes *the exclusive remedy* insofar as a private claim alleges solely that compensation of an adviser subsequent to June 14, 1972, the effective date of §36(b), is so excessive in the sense of surpassing any reasonable relation to the services rendered that its payment is a breach of fiduciary duty." (emphasis supplied)

Since Section 36(b) does not create a right of action enforceable by the Fund's directors, this action is not the typical stockholder's derivative action. The typical action is brought where a corporation has a right, created by statute or otherwise, which the directors are entitled to en-

force but do not enforce. Corporate rights which are enforceable by the directors are created by thousands of statutes, state and federal;* there is no need to expressly provide for a shareholder's derivative action, for if the directors improperly fail to pursue the corporate benefits, a shareholder may act derivatively. Thus, when Congress creates a right of action that, by the express terms of the statute, may be asserted directly by a security holder and not by the corporation, it must be presumed to intend something other than the usual means of derivative procedures for enforcement. However, the Court of Appeals effectively rendered Congress' creation of a shareholder action meaningless.**

B. *The decision of the Court of Appeals below conflicts with a decision of the Court of Appeals for the Third Circuit.*

The courts below held that, even though a § 36(b) action may not be terminated by the board of directors, demand is nevertheless required. For the reasons stated above, we think that this approach is unsound. In this we do not stand alone. The Third Circuit has recently rejected the First Circuit approach, stating that the same standards which govern the permissibility of directorial termination also dictate the requirement, or lack thereof, of shareholder demand:

> "There is no reason why a court, in deciding whether a board is sufficiently interested to excuse demand, should not be informed by the same factors used to

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* For well over a century, corporations have been regarded as juridical persons; *Kentucky Finance Corp.* v. *Paramount Auto Exchange Corp.*, 262 U.S. 544, 550 (1923). Statutes creating rights enforceable by persons have thus created corporate rights as well.

** Congress "adopted the basic principle that . . . there should be effective means for the court to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." S. Rep. No. 91-184, 91st Cong., 1st Sess., p. 2 (1969).

determine whether a court should defer to the board's decision not to pursue the action."

". . . We do not think that we should apply different standards of 'interestedness' to cases in which plaintiff has made no demand and to those in which the demand has been made and rejected." *Lewis* v. *Curtis*, 671 F.2d 779, 785, 786 (3d Cir. 1982).

This observation has especial force in a § 36(b) action, where, as the Court of Appeals conceded, the demand requirement of Rule 23.1 is no more than a "legal vermiform appendix" (31a).

The First Circuit approach is contrary to that of the Third Circuit on an issue which has important ramifications for actions under Section 36(b) as well as for derivative suits generally. Petitioners request the Court to grant certiorari so as to resolve this important conflict among circuits.

CONCLUSION

Shareholder suits in the enforcement of securities laws generally "have played a rather important role" and have served "as a most effective weapon" to supplement action by the Securities and Exchange Commission. *Surowitz* v. *Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966); *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432. The SEC clearly recognized their usefulness in sponsoring the 1970 legislation to enable security holders to perform policing functions which would otherwise require an expansion of governmental activity. The congressional intent should not be frustrated by a judicial invention which, by resulting in the proliferation of demands and special litigation committees, will expand rather than limit litigation.

For the foregoing reasons, it is respectfully submitted that this Court should grant the petition for a writ of certiorari to review the judgment of the Court of Appeals for the First Circuit.

Respectfully submitted,

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APPENDIX

Opinion of District Court

Civ. A. No. 77-3015-T.

United States, District Court, D. Massachusetts.

April 7, 1981.

STANLEY M. GROSSMAN,

Plaintiff,

v.

EDWARD M. JOHNSON, III, *et al.*,

Defendants.

Costello, Sullivan & Hammer, Avram G. Hammer, Boston, Mass., for plaintiff; Richard M. Meyer, Milberg, Weiss, Bershad & Specthrie, New York City, of counsel.

Allison, Clapp, Robert Johnson, McKenzie, Spaulding, Sumner H. Babcock and E. Susan Garsh, Bingham, Dana & Gould, Boston, Mass. and Hunton & Williams, Joseph C. Kearfott, Richmond, Va., for defendants.

Gaston Snow and Ely Bartlett, Peter M. Saparoff, Boston, Mass., for Fidelity Municipal Bond Fund, Inc.

Richard M. Reilly and James S. Dittmar, Berman, Dittmar & Engel, P. C., Boston, Mass., for Fidelity Management & Research Co., FMR Corp., Edward Johnson, Byrnes Loring.

Opinion of District Court

MEMORANDUM

TAURO, *District Judge.*

I.

Plaintiff Stanley M. Grossman (Grossman) is a shareholder of Fidelity Municipal Bond Fund, Inc. (Fund).[1] The Fund is an investment company whose objective is to earn tax-exempt income for its shareholders by investing in municipal bonds. The Fidelity Management & Research Co. (FMR) is the Fund's investment adviser. At all times relevant here, several of the Fund's directors were also directors of FMR and other funds managed by FMR.

On September 30, 1977, Grossman brought this derivative suit against FMR, the Fund, and eight of the nine individual directors of the Fund, charging various breaches of fiduciary duty to the Fund and its shareholders. He did so without first demanding that the directors themselves bring suit on behalf of the Fund.

The complaint breaks down into two major allegations. First, Grossman contends that the Fund pays excessive compensation to FMR for its services as investment advised.[2] Second, he contends that FMR has failed to recapture underwriting commissions[3] for the benefit of the Fund

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[1] In constructing this statement of facts, this court assumes, as it must, that plaintiff's allegations are true.

[2] Throughout a period of substantail growth in the Fund's net assets, FMR's management fee allegedly has remained a fixed percentage of those assets. Hence, FMR's fees has greatly increased, even though the cost of performing its services has not. The result, according to Grossman, is that the Fund pays about 10 percent of its income to FMR, while other municipal bond funds retain well-qualified advisers for as little as .15 percent.

[3] See *Papilsky* v. *Berndt*, 76-77 CCH Fed.Sec.L.Rep. 95,267 (S.D.N.Y. 1976).

and instead has accepted research information from the underwriters. FMR then allegedly uses that research to advise other investment clients. This procedure, Grossman alleges, unjustly benefits FMR and its other clients at the Fund's expense. The gist of Grossman's theory is that the defendants' simultaneous association with the Fund, FMR, and with other investment companies results in two separate conflicts of interest. First, as directors of the Fund, their duty is to keep FMR's fees to a minimum. But, as directors of FMR they have an incentive to keep that company's earnings high by charging excessive advisory fees. Second, as Fund directors they have an obligation to recapture underwriting commissions to the greatest extent possible. As directors of other funds, however, they face the temptation of accepting research information in lieu of cash, so that FMR can use that information in advising those other funds. This interlocking directorship triangle allegedly results in a breach of fiduciary duty to the Fund, in violation of Section 36(b) of the Investment Company Act.

Defendants moved to dismiss, on the grounds that (1) plaintiff had failed to make demand upon the directors to bring suit, as required by Fed.R.Civ.P. 23.1,[4] and (2) plain-

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[4] Rule 23.1 provides, in relevant part:

> In a derivative action brought by one or more shareholders to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and . . . the reasons for his failure to obtain the action or for not making the effort.

tiff did not fairly and adequately represent the interests of the shareholders.[5]

II.

After a few procedural skirmishes not relevant here,[6] this court suggested that it might save everyone a great deal of time and litigation costs if plaintiff would actually make a demand on defendants, even though this lawsuit had already begun. The court theorized that, given an opportunity to consider such a demand, defendants just might respond favorably, or take other remedial action satisfactory to the plaintiff here. Plaintiff followed this suggestion, and on June 19, 1979 wrote a letter to the Fund's board of directors demanding that the Fund either bring suit or realign itself as a plaintiff in this action. The defendants, while maintaining their objections to the suit, agreed that the Fund should fully and fairly consider plaintiff's demand.

This court then stayed action on the dismissal motions for sixty days, and ordered the disinterested directors[7] (i.e. the Fund directors not affiliated with FMR) to review the demand and report back to the court. The disinterested directors delegated responsibility to a Special Committee made up of two non-defendant directors,[8] one of whom

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[5] In view of this court's disposition of the other arguments raised by defendants in support of their motions to dismiss, it is unnecessary to decide the "inadequate representation" issue.

[6] On February 5, 1979, this court allowed plaintiff to amend the complaint. Defendants then moved to dismiss the amended complaint.

[7] The disinterested directors include Dwight L. Allison, Jr., Eugene H. Clapp, II, Robert L. Johnson, George K. McKenzie, and William R. Spaulding.

[8] The two members of the Special Committee were Bertram H. Witham, a director since 1976, and David L. Yunich, who joined the board in 1978.

apparently join[ed] the board after this litigation began. In turn, the Special Committee retained a law firm to investigate the merits of plaintiff's claims. The result was a 230-page report which concluded that the defendants had not violated the relevant statutory provisions, and which recommended that the Special Committee seek to dismiss the complaint. On December 18, 1979, the Special Committee voted to follow that recommendation.

Defendants now move to dismiss once again and, in the alternative, ask for summary judgment. In addition to their previous contentions, they argue that the board has made a good-faith determination that the derivative action should be terminated, and that, under the "business judgment" rule, this cou[rt] must defer to the board's decision and dismiss the case.

III.

A. *The Demand Requirement*

The source of the demand requirement in shareholder derivative suits is Fed.R.Civ.P. 23.1. In pertinent part, the Rule provides:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . ., and the reasons for his failure to obtain the action or for not making the effort.

The Rule "represents a deliberate departure from the relaxed policy of 'notice' pleading promoted elsewhere in the Federal Rules." *Heit v. Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977). Simply stated, it places the burden on the share-

holder "to demonstrate why the directors are incapable of doing their duty." *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1963). The purpose of the demand requirement is "to require resort to the body legally charged with conduct of the company's affairs before licensing suit in the company's name by persons not so charged." *Heit* v. *Baird*, 567 F.2d 1157, 1162 n.6 (1st Cir. 1977). Failure to comply results in dismissal of the complaint. *See, e.g., Lerman* v. *ITB Management Corp.*, 58 F.R.D. 153 (D.Mass. 1973).

As the language of the Rule implies, exceptional circumstances may make demand unnecessary. In general, the plaintiff must allege specific facts clearly demonstrating that the directors of the company would reject a demand if made. *See* 3B *Moore's Federal Practice*, ¶ 23.1.19, at 23.-1-83—.1-89 (2d ed. 1948); *Lerman* v. *ITB Management Corp.*, 58 F.R.D. 153, 156 (D.Mass. 1973). In *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir. 1973), and *Heit* v. *Baird*, 567 F.2d 1157 (1st Cir. 1977), the First Circuit established guiding principles for measuring excuses for a failure to make demand. First, any allegations that directors affiliated with a management adviser "dominate and control" a fund's directorate must be supported by underlying facts. 479 F.2d at 264. Furthermore, mere resistance to the derivative suit by the fund's board of directors does not constitute a sufficient underlying fact. 567 F.2d at 1160. Second, "[t]he plaintiff must show not only that some directors were hostile to his suit because of their self-interest, but that a majority of the board at the time of suit were so implicated in the complained of facts as to make a demand for redress futile." *Id.* Finally, mere

approval by directors of the alleged unlawful action does not constitute sufficient participation in that conduct to excuse demand upon them. *Id.*

Grossman asserts that he made no demand because (1) the Fund's directors are controlled by FMR, and have knowingly participated and acquiesced in the supposedly unlawful conduct; (2) the directors "are operating under a disabling conflict of interest"; and (3) the directors have already stated their belief that the suit is without merit. Amended Complaint, ¶ 18. Under the standards adopted by the First Circuit, however, none of these assertions excuse plaintiff's failure to make demand.

The complaint advances no factual basis for his allegations that FMR "controls" the Fund. Indeed, it is undisputed that at the time of the complaint only three of the nine directors of the Fund were affiliated with FMR. The minority status of the affiliated directors hardly supports, and may well undermine, an inference of control by FMR. Plaintiff's bald assertion of "knowing participation" lacks the specificity necessary for a determination by this court as to whether the directors were "so implicated in the complained of facts as to make a demand for redress futile," as required by the First Circuit in *Heit*. Finally, Grossman's complaint of director "acquiescence" amounts to even less than an allegation of "approval", which the First Circuit rejected as insufficient in both *Heit* and *Kauffman*.

Plaintiff's "conflict of interest" allegations fare no better. The mere fact that some of the Fund's directors are also associated with FMR and with other investment companies does not, standing alone, demonstrate a conflict of interest that would excuse demand. At the time of the complaint, only one-third of the Fund's directors were also

affiliated with FMR. A clear majority of Fund directors, however, would have no apparent conflicting interest that would impede their ability to weigh objectively a claim that FMR fees were "excessive."

On the other hand, it is true that Grossman's "failure to recapture" claim arguably implicates the entire board. FMR allegedly foregoes recapturing commissions that could enure to the Fund's benefit in order to obtain investment advice that is helpful to its management of other funds. As a consequence, plaintiff urges, the Fund directors, all of whom are directors of those other funds, have an incentive to prevent the recapture of those commissions. But plaintiff does not allege that FMR would be unable to obtain the same investment information, even if it implemented a policy of commission recapture. Nothing alleged demonstrates that FMR's destiny is so intertwined with its existing "no recapture" policy that it would be futile to demand a change, even from the interlocking directors. In others words, plaintiff's futility theory presumes motives and biases, even on the part of the interlocking directors, that simply are not warranted by the facts pleaded.[9]

Without merit as well is the argument that the defendants' investigation and rejection of Grossman's claims after this suit was filed excuses a failure to have made such

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[9] It also appears that the legality of recapture by mutual funds is, at best, still in doubt. *See* FMR Defendants' Exhibit A (letter from Glen A. Payne, Special Counsel to the SEC's Division of Investment Management to John W. Belash); Securities Exchange Act of 1934 Release No. 17371 (Dec. 12, 1980); Securities Exchange Act of 1934 Release No. 17129, 45 Fed. Reg. 60529 (Sept. 8, 1980). Although primarily raising issues for disposition of plaintiff's claims on the merits, this uncertainty also undermines plaintiff's contention that the Fund directors had a *duty* to recapture.

a demand prior to suit being brought.[10] Rule 23.1 is clear and unequivocal that, in derivative actions such as this, a shareholder demand must be made of appropriate corporate authorities *before* bringing suit, absent extraordinary circumstances that justify a failure to do so. A post-suit demand simply does not meet the Rule's procedural prerequisite. Plaintiff offers no authority for his *nunc pro tunc* theory, and this court was able to find none. Indeed, such an approach would effectively cripple the spirit and intent of the rule, which is to give corporate authorities an opportunity to deal with shareholder grievances prior to a derivative action being brought.[11]

Similarly without merit is plaintiff's further contention that the requirements of Rule 23.1 are not applicable to actions brought under section 36 of the Investment Company Act. This court rejected that argument once before in *Untermeyer* v. *Fidelity Daily Income Trust*, 79 F.R.D. 36, 44-46 (D.Mass.), *vacated on other grounds*, 580 F.2d 22

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[10] Contrary to plaintiff's assertions, this court did not instruct him to send a demand letter in order to eliminate the demand issue from the case. This court's purpose was to encourage plaintiff to give defendants an opportunity to review his grievances in the hope that expensive and lengthy litigation could be avoided. If nothing else, a *favorable* response to plaintiff's demand would have eliminated that issue from the case.

[11] *Cf. Domaingue* v. *Butterworth*, 641 F.2d 8 (1st Cir. 1981), where the First Circuit adopted a similarly strict view toward satisfaction of procedural prerequisites. In *Domaingue*, the court found that a habeas corpus petitioner had failed to exhaust state remedies, even though it appeared that the petitioner had exhausted his appeal rights in between the time the petition was filed and the time the court decided the case:

> Our practice has been to determine the question of exhaustion as of the time a habeas corpus petition was filed, not as of the time the case is heard on appeal, and to require a new petition to be filed if state remedies are subsequently exhausted.

At 14.

(1st Cir. 1978),[13] and it would be pointless to repeat in detail the analysis relied upon there. Suffice it to say that "unless the congressional intent [to supersede a Federal Rule] is clearly stated, a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." 7 *Moore's Federal Practice* ¶ 86.05, at 86-22. Here, such a construction is more than feasible. Section 36 makes no mention of Rule 23.1, even though the drafters were obviously cognizant of other procedural issues.[15] If anything, its legislative history suggests congressional intent to retain the demand requirement.[14]

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[13] In *Untermeyer*, the First Circuit vacated this court's judgment on the ground that demand is excused when half the board consists of "interested" directors. 580 F.2d at 24. The necessary premise of the First Circuit's holding, however, was that Rule 23.1 did in fact apply to a suit under section 36(b).

[15] Among other provisions, the statute excuses plaintiff from proving personal misconduct on the part of any defendant; permits consideration by the court of ratification of compensation contracts by shareholders; and limits damages to "actual damages", recoverable only for the period one year prior to the initiation of the action. 15 U.S.C. § 80a-35(b)(1-3).

[14] Congress was alert to the safeguards that would be afforded by the Federal Rules of Civil Procedure against frivolous suits under Section 36. For example, the Chairman of the SEC, responding to fears that the proposed legislation would open the door to unjustified strike suits, reported:

> We do not believe that this would leave the door wide open to nuisance actions. As we have pointed out previously, there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation.

Hearing on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737, before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. 201 (1969).

The SEC Chairman also testified, "There are already in [the bill] and in the FRCP sufficient safeguards against frivolous or harassing lawsuits." *Id.* at 860.

Moreover, other provisions of the Act place disinterested directors in a watchdog role over relations between funds and their advisers.[15] It would be incongruous to ascribe to Congress an intent to allow individual shareholders to sue on behalf of a corporation without first making demand upon those statutorily charged with such responsibility.[16] It makes more sense to presume that Congress intended that the disinterested directors at least have the opportunity to pass on the merit of a shareholder grievance, before the fund became immersed in litigation.

B. *The Business Judgment Rule*

The plaintiff's failure to comply with Rule 23.1 warrants dismissal of the complaint. But even if we assume that plaintiff's post-complaint demand constitutes compliance wih Rule 23.1, the "business judgment" doctrine poses another obstacle to the continuation of this suit.

After plaintiff finally sent a demand letter in this action, a special committee of disinterested directors investigated his claims and concluded that prosecution of the suit was not in the best interests of the Fund and its shareholders. The issue then becomes whether this court, in a suit brought under section 36(b), must defer to the special committee's "business judgment" and, therefore, dismiss this action.

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[15] Congress has insisted that a certain proportion of an investment fund board be disinterested, 15 U.S.C. §§ 80a-10(a), (d), and that these individuals review the contracts for fees to the investment advisers. *Id.* § 80a-15(c).

[16] Plaintiff also analogizes section 36(b) to section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), which is exempt from the demand requirement of Rule 23.1. Section 16(b), however, is patently inapposite—unlike section 36(b), it contains its own demand requirement.

In *Burks* v. *Lasker*, 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed. 2d 404 (1979), the Supreme Court considered precisely this issue with respect to other sections of the Act. Justice Brennan arrived at a two-step procedure for determining directors' termination rights:

> The threshold inquiry for a federal court [is] to determine whether state law permit[s] disinterested directors to terminate [the derivative] suit. If so, the next inquiry [is] whether such a state rule [is] consistent with the policy of the ICA.

Id. at 480, 99 S.Ct. at 1834.

In applying this method of inquiry to the present case, the first point of reference is the law of Maryland, the Fund's state of incorporation.[17] The Maryland Court of Appeals has firmly adopted the business judgment rule. In *Parish* v. *Maryland & Virginia Milk Producers Ass'n*, 250 Md. 24, 242 A.2d 512 (1968), *cert. denied*, 404 U.S. 940, 92 S.Ct. 280, 30 L.Ed.2d 253 (1971), the plaintiff brought a derivative action against a milk cooperative and its directors, charging that a sale of certain property constituted waste of the cooperative's assets. In considering plaintiff's claims, the court applied the business judgment rule:

> It is well established that courts generally will not interfere with the internal management of a corporation at the request of a minority stockholder or a member. The conduct of the corporation's affairs are placed in the hands of the board of directors and if the majority of the board properly exercises its business judgment, the directors are ordinarily not liable. . . . It is not the

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[17] *See, e.g., Lewis* v. *Anderson*, 615 F.2d 778, 781 (9th Cir. 1979); *Abbey* v. *Control Data Corp.*, 603 F.2d 724, 728-29 (8th Cir. 1979).

> function of a court of equity to attempt to substitute its judgment . . . *once it has been determined that their conduct is neither ultra vires, fraudulent, illegal nor grossly negligent.*

Id. at 540, 541. *Accord, Devereux* v. *Berger,* 264 Md. 20, 284 A.2d 605, 612 (1971).

The Maryland courts, however, have apparently not considered the application of the business judgment rule to termination of a derivative suit. It is appropriate, therefore, to consider decisions from other jurisdictions, in an effort to divine a majority trend which Maryland would likely follow. *See Lewis* v. *Anderson,* 615 F.2d 778, 781 (9th Cir. 1979).

Although the business judgment rule has not been unanimously extended to cover termination decisions, the "clear trend in corporate law", *id.* at 783, favors such an extension where the termination decision is made by a special committee of disinterested directors. *See, e.g., id.* (interpreting California law); *Abbey* v. *Control Data Corp.,* 603 F.2d 724, 729 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017, 100 S.Ct. 670, 62 L.Ed.2d 647 (1980) (interpreting Delaware law); *Genzer* v. *Cunningham,* 498 F.Supp. 682, 686-89 (E.D. Mich. 1980) (interpreting Michigan law); *Maldonado* v. *Flynn,* 485 F.Supp. 274, 278-79 (S.D.N.Y. 1980) (interpreting Delaware law); *Auerbach* v. *Bennett,* 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994, 996 (N.Y. 1979) (interpreting New York law). *But see Maldonado* v. *Flynn,* 413 A.2d 1251, 1257 (Del.Ch. 1980) (interpreting Delaware law), *dismissal contingently granted on res judicata grounds,* 417 A.2d 378 (Del Ch. 1980). This court concludes that Maryland courts would most likely follow this trend and permit a business judgment to terminate a suit and, therefore,

holds that Maryland law permits disinterested directors, in the exercise of their business judgment, to terminate a derivative suit.

The second step in the *Burks* approach is to determine whether applicable state law is consistent with the policies behind the Investment Company Act. An appropriate starting point is the language of the Act. Section 36(b)(2) provides, in pertinent part:

> In any [action brought under section 36(b)] approval by the board of directors of such investment company of [payments to an investment adviser], or of contracts or other arrangements providing for such compensation or payments . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances.

15 U.S.C. § 80a-35(b)(2). Although the statute does not explicitly deal with decisions to terminate litigation, the term "approval" could be construed to encompass actions taken by a board to dismiss shareholder challenges. Under such a reading, the phrase "as is deemed appropriate under all the circumstances" would then call for some sort of case-by-case determination of whether the board's attempt to dismiss is proper.

Other sections of the Act reflect a somewhat different theme—the watchdog role of the disinterested directors. Under 15 U.S.C. § 80a-10(a), (d), a certain proportion of the board of an investment fund must be disinterested. Moreover, the disinterested directors must review the fees paid to investment advisers. *Id.* § 15(c). The legislative history of section 36(b) reemphasizes this federal policy of encouraging the unaffiliated directors to enforce management's fiduciary duty:

> These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.

[1970] *U.S. Code Cong. & Ad.News* 4897, 4903 (reprinting S.Rep. No. 91-184, 91st Cong., 2d Sess.).

The most recent analysis of federal policy comes from the *Burks* decision itself. In *Burks*, the Court recognized Congressional concern over the "potential for abuse inherent in the structure of investment companies," which are generally operated not by their own employees but by investment advisers. 441 U.S. at 480, 99 S.Ct. at 1834. But the Court also observed that the "cornerstone" of Congress's attack upon such abuse was the statutory requirement that at least 40 percent of the board of a mutual fund be made up of disinterested directors. *Id.* at 482, 99 S.Ct. at 1839. The Congressional design, therefore, was to entrust the independent directors with "the primary responsibility for looking after the interests of the funds' shareholders." *Id.* at 485, 99 S.Ct. at 1840. The Court concluded that, at least in some cases, federal policy would best be served by allowing the disinterested directors to exercise that responsibility and terminate a suit:

> Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon "watchdogs"

> to protect shareholder interests and yet, where the "watchdogs" have done precisely that, require that they be totally muzzled.

Id.

The evidence thus given rise to two separate inferences about federal policy. The first is that Congress wished the judiciary to have some power to examine termination decisions on a case-by-case basis. The second inference, counterbalancing the first, is that Congress wished to place the primary responsibility for protecting corporate interests in the hands of the disinterested directors, not the courts. Each of the positions advocated by the parties rests on one inference at the expense of the other. Plaintiff urges that the business judgment rule should never bar derivative suits under section 36(b).[18] But that stance utterly ignores the role of the disinterested director as an independent check upon management. Defendants, on the other hand, argue for a straightforward application of the Maryland business judgment rule to termination decisions. While perhaps closer to the federal policy, this approach seems to undervalue the statutory command that broad approval be given "such consideration by the court as is deemed appropriate under all the circumstances."

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[18] In support, plaintiff cites the following language from *Burks*: "And when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b) . . . performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees." 441 U.S. at 484, 99 S.Ct. at 1840. This court does not regard the proffered language as being controlling for two reasons. In the first place, the power to terminate under section 36(b) was not at issue in *Burks* and therefore the quote is dictum. Moreover, as previously demonstrated, there are strong indicia of Congressional intent to allow termination under some circumstances.

The best way to weave together these disparate strands of federal policy is to defer to the disinterested directors' business judgment, provided that the exercise of that judgment is reasonable under the circumstances.[19] Though roughly similar to the Maryland business judgment rule, which permits reversal of a fraudulent, illegal, or grossly negligent decision, a "reasonableness" inquiry includes some scrutiny of the investigation conducted by the special committee before reaching its conclusion. If the investigation is independent and has sufficient depth to provide a reasonable basis for the directors' decision to seek dismissal, then deference to that decision is appropriate. If not, then the decision can be given some weight, or none at all, depending on the level of investigation conducted. A rule of reasonableness allows for a case-by-case review of the special committee's decisions, without removing the primary burden of protecting corporate interests from the shoulders of the disinterested directors.

In short, federal policy requires a slightly stricter standard of review than that contained in the Maryland business judgment rule. Applying this reasonableness standard to the uncontroverted facts of this case, it is clear that the decision to terminate rested on a thorough and independent consideration of plaintiff's claims. It is undisputed that the special committee retained a law firm having no prior relationship with the Fund. That law firm undertook an investigation spanning several months, in the course of which it (1) reviewed minutes of board and committee meetings,

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[19] At least one court has undertaken a similar, although somewhat more intrusive, inquiry in applying a standard business judgment rule. *See Rosengarten* v. *International Tel. & Tel. Corp.*, 466 F.Supp. 817, 822-28 (S.D.N.Y. 1979). *See generally* Note, *The Business Judgment Rule In Derivative Suits Against Directors*, 65 Cornell L.Rev. 600, 614-15 (1980).

selected financial information, and other documents and correspondence; (2) interviewed individuals active in the management of FMR, present and former Fund directors, auditors, representatives of other investment companies, representatives of government agencies, and counsel for the Fund and directors; and (3) carried out appropriate legal research. The result was a 230-page report fully analyzing the factual and legal issues raised by the demand letter, and finally concluding that plaintiff's claims lacked merit.

Plaintiff has given this court no reason to doubt either the independence or integrity of the Special Committee's investigation. This court, therefore, must uphold the Committee's decision to terminate the suit. Accordingly, defendants' motions for summary judgment are allowed.

An alternative order of judgment will issue.

Judgment of District Court

UNITED STATES DISTRICT COURT

DISTRICT OF MASSACHUSETTS

CA 77-3015-T

STANLEY M. GROSSMAN,

Plaintiff,

v.

EDWARD M. JOHNSON, III, *et al.*,

Defendants.

ORDER OF JUDGMENT

April 7, 1981

TAURO, D.J.

For the reasons stated in an opinion issued this date, defendants' motion to dismiss and for summary judgment are alternatively allowed.[1] It is ordered that judgment enter, and judgment is hereby entered, in favor of defendants on the alternative grounds that

1) Plaintiff has failed to comply with Fed. R. Civ. P. 23.1; and

2) Defendants' alleged actions are protected by and comply with the requirements of the business judgment rules.

/s/ J. TAURO
United States District Judge

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[1] *Cf. Corey* v. *Look*, No. 80-1447 (1st Cir. Feb. 13, 1981).

Opinion of Court of Appeals

United States Court of Appeals
For the First Circuit

No. 81-1348

STANLEY M. GROSSMAN,

PLAINTIFF-APPELLANT,

v.

EDWARD C. JOHNSON, 3rd, ET AL.,

DEFENDANTS-APPELLEES.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

[HON. JOSEPH L. TAURO, *U.S. District Judge*]

Before
CAMPBELL, and BOWNES, *Circuit Judges*,
and DAVIS, *Judge*.*

Richard M. Meyer, with whom *Avrum G. Hammer*, and *Milberg, Weiss, Bershad & Specthrie* were on brief, for appellant.

James S. Dittmar, with whom *Berman, Dittmar and Engel, P.C.* was on brief, for appellees Edward C. Johnson, 3d, et al.

E. Milton Farley, III., with whom *Sumner H. Babcock, E. Susan Garsh, Bingham, Dana & Gould, John W. Riely, Joseph C. Kearfott*, and *Hunton & Williams* were on brief, for appellees Dwight L. Allison, Jr., et al.

Jerome P. Facher, with whom *Harry T. Daniels, James R. Gomes, Hale and Dorr, Peter M. Saparoff*, and *Gaston Snow & Ely Bartlett* were on brief, for appellee Fidelity Municipal Bond Fund, Inc.

Richard A. Kirby, Special Counsel, with whom *Ralph C. Ferrara*, General Counsel, *Paul Gonson*, Solicitor, *Edward F. Greene*, General Counsel, *Jacob H. Stillman*, Associate General Counsel, *Robert Mills* and *Louis C. Whitcett*, Attorneys, were on briefs, for the Securities and Exchange Commission, amicus curiae.

March 29, 1982

DAVIS, *Judge*. Plaintiff-appellant Stanley M. Grossman brought this derivative action in the District Court for Massachusetts, under the Investment Company Act of 1940,

* Of the United States Court of Claims, sitting by designation.

as amended, 15 U.S.C. §§ 80a-1 *et seq.* (1976) (the Act).[1] He is and has been a shareholder of Fidelity Municipal Bond Fund, Inc. ("the Fund"), a registered open-end investment company, and he sues the Fund's investment adviser, Fidelity Management & Research Company ("FMR"), the corporation that is the sole owner of that adviser ("FMR Corp."), the affiliated directors of the Fund, as well as most of the unaffiliated directors (whom we shall call "disinterested").[2] Against these defendants, Grossman makes two charges: (a) breach of fiduciary duty to the Fund with respect to the allegedly excessive amount of advisory fees paid to FMR by the Fund; and (b) breach of fiduciary duty to the Fund by failing to recapture (or have recaptured) excessive underwriting commissions, discounts and spreads paid by the Fund on its purchases of securities. Before instituting the suit, plaintiff made no demand on the Fund or its directors to bring or prosecute an action on either of these two bases.

Defendants moved to dismiss the complaint, asserting, as one point, that plaintiff had failed to comply with Rule 23.1 of the Federal Rules of Civil Procedure, governing demand by shareholders in derivative actions. During the lengthy argument on those motions, the District Court suggested that it might be advisable, it might even end the controversy, for plaintiff to send a demand letter to the directors specifying his position, although the litigation had already commenced. After consideration, plaintiff did make such demand.

The District Court then stayed action on the motion and ordered the "disinterested" directors[3] to review the demand

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[1] For the purposes of our limited disposition, we rest on facts alleged by plaintiff in his amended complaint, and merely capsule the facts and proceedings.

[2] The "affiliated" directors own 5% or more of the shares of FMR Corp. and are officers and directors of FMR. The "unaffiliated" directors do not have those connections with FMR and FMR Corp.

[3] These were the "unaffiliated" director defendants, plus one unaffiliated director who had not been sued though he had previously joined the board, and one unaffiliated director who became a board member after the suit had been brought (and accordingly was not sued).

and report back to the court. These directors delegated responsibility to a Special Committee composed of the two directors who were not defendants (*see* note 3, *supra*). The latter retained a former Chairman of the Securities and Exchange Commission (and his outside law firm) to make a study and render a report on the issues presented by plaintiff's demand. A lengthy report was made, concluding that there had been no statutory violation or breach of fiduciary duty on either branch of the suit, and recommending that the Special Committee seek to have this suit dismissed. The Committee accepted that recommendation.

Defendants then moved to dismiss the amended complaint,[4] and, alternatively, for summary judgment, urging two grounds which the District Court considered: (a) the failure to make a proper and timely demand, and (b) the court should accept the Special Committee's good faith "business judgment" that the suit should be terminated. In the decision now before us, the District Court accepted both of these contentions, alternatively. 89 F.R.D. 656 (1981). Judgment was entered for defendants. For the reasons to be given in Parts I, II and III of this opinion, we affirm on the former ground, by-passing the latter.

I.

Rule 23.1 of the Rules of Civil Procedure ("Derivative Actions by Shareholders") declares:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter de-

[4] In the course of the proceedings plaintiff had been permitted to file an amended complaint.

> volved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Plaintiff urges that Rule 23.1 is wholly inapplicable to that portion of his case charging the payment of excessive advisory fees to the investment adviser (FMR), which is brought under the special provisions of section 36(b) of the Act, 15 U.S.C. § 80a-35(b) (1976). In this segment of our opinion we consider that contention.[8]

Section 36(b), added in 1970, prescribes a separate statutory claim for excessive advisory fees to an investment

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[8] Plaintiff also says that, even if Rule 23.1 applies, he was excused from making a demand on the directors for this aspect of his complaint. We discuss that point in Part II, *infra*. As for the recapture of commissions, Grossman does not argue that Rule 23.1 is wholly inapplicable; he mainly says, instead, that he was excused from making a demand. We also consider that argument in Part II, *infra*. On both sectors of his case, plaintiff insists, in addition, that the demand he made after the beginning of the suit was adequate compliance with Rule 23.1. Part III, *infra*, deals with that premise.

The Securities and Exchange Commission, which participated in this appeal as amicus curiae, takes no position on the applicability of the demand provisions of Rule 23.1 or the alleged excuses for noncompliance.

adviser.[6] The Securities and Exchange Commission and security holders of the investment company are specifically

[6] The relevant parts of section 36(b) read:

"(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments [including directors], for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2 In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient."

authorized to sue "on behalf of such company" to recover such fees. The section (among other limitations) places on the plaintiff the burden of proof of showing a breach of fiduciary duty, restricts monetary relief to actual damages and to the persons receiving such compensation, establishes a one-year statute of limitations on recovery, and provides that approval or ratification by the paying company's directors of the compensation to the investment adviser "shall be given such consideration by the court as is deemed appropriate under all the circumstances."

There is no express reference to Rule 23.1 or to demand by the suing shareholder, but plaintiff gives several reasons why, in his view, the structure, terms, and purpose of the provision show that the Rule is wholly inapplicable to such excessive fee suits. We divide these arguments into three groups, first, those that we believe to have little merit, second, those that have substantial weight but are subject to countervailing arguments which likewise have merit, and then we discuss the considerations we believe to tip the balance against plaintiff on this question.

*A.*1. Appellant says initially that Rule 23.1 must be wholly inapplicable because, though the statute says that suit must be brought on behalf of the investment company and in that sense is a "derivative" action, section 36(b) does not permit an action by the investment company itself (but only by the SEC or a security holder).[7] We cannot believe, however, that, for example, a new and independent board of directors, intent on recovering excessive fees from the investment adviser, would be precluded from suing under section 36(b).[8]

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[7] The first sentence of Rule 23.1, *supra*, requires that "the corporation or association [shall have] failed to enforce a right *which may properly be asserted by it*" (emphasis added).

[8] One reason why the directors might wish to use section 36(b), instead of employing a more conventional corporate suit, is that subsection (1) expressly removes the need to allege or prove "personal misconduct" on the part of any defendant. In addition, the general standard for recovery might be easier under section 36(b) than in a non-statutory action.

That section is explicit that recovery by a shareholder is to be on behalf of the investment company and that his suit must be brought on the same behalf. With those clear requirements, Congress could well have believed that, though it was appropriate to specify that the Commission and shareholders had the new statutory cause of action under section 36(b), *see Moses v. Burgin*, 445 F.2d 369, 373 n.7 (1st Cir. 1971), it was unnecessary to say with particularity that the company also did. A suit "on behalf of such company" (a phrase which is more than merely one "for the benefit of the company") is normally a derivative action that the company could itself bring.

Plaintiff, whose complaint and amended complaint both allege that he brings this action "derivatively on behalf of the Fund," seems to have originally agreed that his suit under this section could have been brought by the Fund. Although subsection (3) directly forbids an action under section 36(b) against any person "other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments" — barring as defendants, in this instance, the "disinterested" directors and the Fund itself — this whole proceeding (including that part under section 36(b)) was brought against those "forbidden" defendants,[9] apparently on the correct assumption that this is a derivative suit to enforce rights the Fund could itself enforce, and in which the company and its directors should be joined in the ordinary fashion.

2. Another of plaintiff's points we reject outright is the analogy to section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1976) ("profits from purchase and sale of security within six months"), which has been held excluded from certain non-demand parts of Rule 23.1. *Dottenheim v. Murchison*, 227 F.2d 737, 739-741 (5th Cir. 1955), *cert. denied*, 351 U.S. 919 (1956); *Blau v. Mission Corp.*, 212

[9] This is also true of the amended complaint.

F.2d 77, 79 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954). On the demand point, however, section 16(b) is plainly inapposite because it embodies its own express demand requirement different from that in Rule 23.1.[10] If anything, that special demand provision indicates that Congress considered a demand essential for a shareholder suit even though Congress may have dispensed with other aspects of what is now Rule 23.1.

3. A related argument we cannot accept is that section 36(b) speaks of suit by a "security holder", a term which it is said could cover pure debenture holders or other bare creditors who, not being shareholders or members, cannot comply with the demand aspects of Rule 23.1. The simple answer, we think, is that Congress used the general term "security holder" in section 36(b) to cover shareholders of mutual funds and like investors akin to stockholders, whom Rule 23.1 undoubtedly fits. The phrase was not designed to allow mere creditors to make use of section 36(b).[11]

B. Plaintiff makes three stronger arguments for total exclusion of the demand requirement of Rule 23.1 — but each seems to us to have a substantial counterbalance.

1. Grossman's chief claim is that a demand would be futile because the directors, even the "disinterested" ones, cannot by themselves terminate a section 36(b) suit through the good faith exercise of reasonable "business judgment". We do not today decide whether or not the directors are so disabled — but it is undeniable that there are very serious reasons for accepting that proposition. *Burks v. Lasker*, 441 U.S. 471, 484 (1979), a case on the directors' power to terminate a suit

[10] Suit may be brought "if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter ***." 15 U.S.C. § 78p(6).

[11] The legislative history of § 36(b) speaks of suits thereunder by "shareholders". *See* S. REP. NO. 184, 91st Cong., 1st Sess., *reprinted in* [1970] U.S. CODE CONG. & AD. NEWS 4897, 4910; H.R. REP. NO. 2337, 89th Cong., 2d Sess. 143, 146 (1966) (SEC report); 115 CONG. REC. 13699 (1969); *Investment Company Act Amendments of 1969: Hearings of the Senate Committee on Banking and Currency*, 91st Cong., 1st Sess. 1-2 (1969).

under other portions of the Act where section 36(b) was not involved, expressly contrasted the latter provision: "And when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), 84 Stat. 1428, 15 U.S.C. § 80-a-35(b)(2), added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees."[12] The Supreme Court was referring to § 36(b)(2) (note 6, *supra*) which can easily be read to give the court, rather than the directors, the ultimate power to decide the propriety of the fees.

Nevertheless, even on that interpretation of the statute, a demand would not be futile. It would give the independent directors the opportunity to study the problem and decide whether to accede, in whole or in part, to the complainant's views. When it added § 36(b), Congress also deliberately strengthened the position of independent directors, including their dealing with advisory fees. *See Burks v. Lasker, supra,* 441 U.S. at 482-485. They were not designed to be ciphers or to be overlooked. Although the court would decide for itself (on the view we accept *arguendo*) the merits of the claim of excessive compensation, the independent and disinterested directors still have a substantial role. Surely, their decision to side with the complainant (entirely or in part) would have important consequences, and even their knowledgeable disagreement with the demand might be deemed worthy by the court of grave consideration under § 36(b)(2).

2. Plaintiff's appeal to the legislative history (of the 1970 amendments) to show that section 36(b) was exempted from the demand requirement of Rule 23.1 seems, at the very best for him, to end in a draw. There was, as he points out, emphasis on the prior ineffectiveness of independent directors

[12] Though this statement may technically have been "dictum" in the sense that *Burks* did not itself involve section 36(b), the Court's observation formed an integral part of its reasons for holding that the directors had broader powers under other parts of the Act. The statement was by no means gratuitous or *obiter*.

with respect to advisory fees, the need for strengthening then section 36, and the significant role of the courts in determining the proper level of fees. *See* the *S.E.C. 1966 Report on Investment Companies*, H.R. REP. No. 2337, 89th Cong., 2d Sess., 131, 143, 146 (1966); *Investment Company Act Amendments of 1969: Hearings of the Senate Committee on Banking and Currency*, 91st Cong., 1st Sess. 1-2 (1969); S. REP. No. 184, 91st Cong., 1st Sess., 2, 6-7, *reprinted in* [1970] U.S. CODE CONG. & AD. NEWS 4897, 4898, 4903; 115 CONG. REC. 13699 (1969). But these themes are all fully consistent with the continued operation of the demand part of Rule 23.1, which would not impede or contradict any of the stated purposes. Indeed, the history shows an equal and concurrent stress on the authority and responsibility of the directors. S. REP. No. 184, 91st Cong., 1st Sess. 7, *reprinted in* [1970] U.S. CODE CONG. & AD. NEWS 4897, 4903. ("The section [section 36(b)] is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary"; and "the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors"). At the same time, there was a concern to discourage unjustified derivative suits. H.R. REP. No. 1382, 91st Cong., 2d Sess. 8 (1970); *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 201, 662, 860 (1969). That aim is closely connected with Rule 23.1, which has such a goal among its functions.

When the inquiry narrows down to the continued relevance of the Federal Rules, especially Rule 23.1, there is some direct indication that the Rules were or may have been regarded as barriers to unjustified derivative suits. The Chairman of the Securities and Exchange Commission so reported. *Id.* at 201 ("*** there are adequate safeguards

under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation"); to the same effect, *see id.* at 860, where the Chairman specifically mentioned "*e.g.* Rule 23, FRCP" as one of the "sufficient safeguards against frivolous or harassing lawsuits." Plaintiff cites a comment of another Commissioner disfavoring "the interposition of procedural obstacles", *Investment Company Act Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess. 30 (1969), but this was a reference, not to the demand requirement of Rule 23.1, but to a proposed provision that a suing shareholder must own a specified percentage of stock or represent a stated amount of the investment fund's assets.

3. Lastly, plaintiff invokes the short one-year limitation period on damages[13] as sufficient reason for exempting § 36(b) cases from the demand provision of Rule 23.1 — the time taken by demand-and-response before institution of an action would, it is argued, diminish the period and the amount of recovery. The truth is, however, that ordinarily the demand requirement could change the particular one-year period for which recovery was allowable but would not reduce the one-year recovery period, and probably not decrease the amount. In the unusual case in which the amount of recovery could actually be reduced by directors' dawdling or the taking of excessive time to reply to a demand, a district court could allow suit to go forward without awaiting a response. *See Mills v. Esmark, Inc.*, 91 F.R.D. 70, 73 (N.D. Ill. 1981).

C. The residue of our discussion (to this point) is that there is no strong reason for wholly excluding section 36(b) from the demand requirement, or for thinking that Congress intended that result. In subpart A, *supra*, we have rejected some of plaintiff's contentions outright, and in subpart B we have found that each of his more substantial points has a fair and equivalent counterpoise. The decisive factor, we must

[13] Section 36(b)(3) (note 6, *supra*) provides: "No award of damages shall be recoverable for any period prior to one year before the action was instituted."

conclude, is that there is no persuasive indication that, in adopting section 36(b), Congress wished to repeal or limit the demand provision of Rule 23.1 which has long been a general part of our federal law of practice and procedure, governing almost all derivative actions in federal courts.

In the absence of a "clear inconsistency" or a demonstrated congressional purpose to exclude one or more of the Federal Rules, "a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible." 7 MOORE'S FEDERAL PRACTICE, ¶ 86.04[4] at 86-22 (2d ed. 1980); *United States v. Gustin-Bacon Division, Certain-Teed Products Corp.*, 426 F.2d 539, 542 (10th Cir.), *cert. denied*, 400 U.S. 832 (1970); *see also*, 4 C. WRIGHT & A. MILLER, FEDERAL PRACTICE & PROCEDURE, § 1001 at 30-31 (1969 ed.).[14] That harmonization is quite feasible for section 36(b). Perhaps for such actions the demand requirement of Rule 23.1 may tend toward the status of a legal vermiform appendix — the provision's utility may be reduced sharply in § 36(b) litigation — but the demand requirement still has a function to perform and is not totally without purpose or effect. In those circumstances it is not for the courts to hold inapplicable the demand requirement "which continues a long tradition in the federal courts," *Heit v. Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977), where Congress has not done so, explicitly or by solid implication.[15]

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[14] Compare this principle with the canon against implied repeals of statutes in the absence of clear intention to do so or repugnancy of the latter to the earlier legislation. *Morton v. Mancari*, 417 U.S. 535, 551 (1974); *Georgia v. Pennsylvania R. R.*, 324 U.S. 439, 456-57 (1945).

[15] In *General Telephone Co. v. EEOC*, 446 U.S. 318 (1980), the Supreme Court ruled — on the basis of a "straightforward" reading of § 706 of the Civil Rights Act of 1964, the legislative intent underlying the 1972 amendments to Title VII, and the enforcement procedures under Title VII — that the EEOC's enforcement action was not properly characterized as a "class action" subject to the procedural requirements of Rule 23. As we have said, comparable factors are absent here.

II

If, as we have held in Part I, *supra*, a § 36(b) action is not exempt from the demand portion of Rule 23.1, we must confront Grossman's secondary argument that, in any event, he was excused (as to the 36(b) portion of his suit) from making demand. He takes a parallel position for the "recapture" part of his action (which is not brought under § 36(b) and as to which plaintiff makes no claim of a complete exemption from the Rule). Rule 23.1 mandates that the complaint "shall also allege with particularity the efforts, if any, made by plaintiff to obtain the action he desires from the directors *** and the reasons for his failure to obtain the action or for not making the effort." In this circuit that requirement has been "vigorously enforced." *Heit v. Baird*, *supra*, 567 F.2d at 1160. "The futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight." *Cramer v. General Telephone & Electronics Corp.*, 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

1. On the advisory fees (the § 36(b) claim), plaintiff's only excuses are that the Fund's directors were controlled by or affiliated with FMR, had participated in the alleged wrong, and had announced their opposition to the suit. All three reasons are inadequate. Of the eight Fund director-defendants, only three were affiliated with FMR; five were unaffiliated and "disinterested."[16] As the court said in

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In addition to the court below, three district courts have passed directly on the applicability of the demand requirement of Rule 23.1 to suits under section 36(b). Two have held Rule 23.1 applicable. *Markowitz v. Brody*, 90 F.R.D. 542, 548-49, 554-55, 559-61 (S.D.N.Y. 1981); *Weiss v. Temporary Investment Fund, Inc.*, 516 F. Supp. 665, 668-70 (D. Del. 1981), *rehearing denied*, 520 F. Supp. 1098 (1981). One court held primarily that demand was futile in that instance and therefore excused under Rule 23.1, but was also "inclined to agree with plaintiffs that a demand on the directors of the Fund was not intended to be a prerequisite to suit under § 36(b)." *Blatt v. Dean Witter Reynolds Intercapital, Inc.*, S.D.N.Y., No. 79 Civ. 5489 (MEL) (Jan. 7, 1982).

[16] One disinterested director (who was apparently such at the time suit was begun) was not sued.

Untermeyer v. Fidelity Daily Income Trust, 580 F.2d 22, 23 (1st Cir. 1978), and *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 264 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), a majority of disinterested directors negatives general allegations of control-by-the-adviser, comparable to those plaintiff makes here. A proper excuse of control or domination calls for particularized allegations and specific facts — which are absent both in the initial and the amended complaint.

As for mere "participation" or "acquiescence" by the directors in the level of the challenged advisory fees, that generality, too, is an insufficient excuse where the corporate activity is the normal one of setting and paying advisory fees; on this point, there also are no particulars asserting that a majority of the directors engaged in a "facially improper transaction." Bare allegations of "wrongful participation" or "acquiescence" are not enough in this circuit. *See In re Kauffman Mutual Fund Actions*, *supra*, 479 F.2d at 264-65; *Heit v. Baird*, *supra*, 567 F.2d at 1160-62.

The third allegation, that the directors had already announced their firm opposition to the suit, is equally unavailing. Apart from the critical fact that the statement on which plaintiff relies in his amended complaint did not precede the suit but was part of a motion to dismiss the initial complaint, there is no doubt whatever that, in context, the disinterested directors' position did not preclude their fair consideration of plaintiff's demand.[17]

2. The primary excuse for failing to make demand on the "recapture" element of the case is that the directors all had a

[17] The full statement was: "The Disinterested Directors have no basis for believing that suit against FMR for the practices alleged in the Complaint is justified. They are anxious, however, to evaluate any information which Grossman has which suggests that it is. If they conclude that suit is justified, the Fund's best interests demand that they bring suit. They will do so."

As ground for his excuse, Grossman quotes only the first sentence, omitting the remainder.

conflict of interest.[18] The gist of this claim is that FMR should have recovered a substantial portion of underwriting commissions, discounts and spreads paid on the Fund's purchases of municipal bonds, but failed to do so "because FMR received from the underwriters substantial benefits in the form of research, statistical and other information in connection with FMR's functions as investment adviser *to the other funds which it manages*" (emphasis added). The posited conflict-of-interest arises because all the Fund's directors are directors or trustees of other funds managed by FMR, and as such directors or trustees (it is asserted) would have an interest adverse to recapture for the Fund, so that the other funds could continue to receive the information they need and want.

We can assume *arguendo* that there might arguably be some duty to recapture as charged in the complaint, but the difficulty with plaintiff's general assumption of "conflict of interest," as an excuse for not making demand, is that he fails to set forth with any specificality, as Rule 23.1 and our decisions require, the factual grounds why this putative "conflict of interest" was in fact an actual one. The conflicting status of the Fund's directors here was at best tenuous and conditional, not direct, stark, apparent and "unmistakable" as in *Delaware & Hudson Co. v. Albany & Susquehanna Railroad*, 213 U.S. 435 (1909). The responsibility both for supplying the information to the other funds and for recapture was, not on the other funds, but on FMR, with which a majority of the Fund's board were unconnected. The same is true of the financial detriment of recapture, which would fall on FMR; the other funds would not be interested in that money. They may be concerned with continuing to receive

[18] Plaintiff also says, on this phase, that the directors had announced their firm opposition to the merits of his recapture claim. On that, the answer we have already given (*see* note 17, *supra*, and text) suffices.

the information,[19] but there is no allegation or reason to believe that they would not be satisfied if FMR obtained it elsewhere than from underwriters, brokers or dealers. Although there is an allegation that recapture would diminish the amount of information supplied by the latter, there is no assertion that FMR (which had the duty to supply it) would not be able to, or would not, fill the gap from another source, nor is there any assertion that the other funds would have to pay FMR higher fees in order to obtain the information they wanted. To charge a true conflict of interest the plaintiff should have at least spelled out the likelihood of one, not left the court with the bare possibility that the defendants might conceivably have the incentive to vote or push against recapture because of their interests as directors of the other funds. *Heit v. Baird, supra*, 567 F.2d at 1161-62, indicates that the bare possibility or more allegation that the directors could have a self-interested purpose (there, to retain control of the corporation; here, to advance the interests of the other funds) is not enough if, as in this case, there can be valid corporate reasons for taking the position challenged in the complaint — or if there is in fact no conflict because of other circumstances not negated by plaintiff. Conversely, "the antagonism between the directory and the corporate interest" must be shown to be "unmistakable," or deemed futile, to excuse demand. *Delaware & Hudson Co. v. Albany & Susquehanna Railroad*, 213 U.S. 435, 447 (1909); *In re Kauffman Mutual Fund Actions, supra*, 479 F.2d at 263.

III

The final question is whether plaintiff's post-litigation demand cured his failure to make one before beginning the action. Rule 23.1 specifically calls upon the complaint to show that demand was made or was properly excused; there is no provision for thereafter remedying an omission in the same suit, especially after the defendants have moved to dismiss

[19] There are, however, no particularized allegations on the necessity or importance of the other funds' continuing to receive the information.

because of the absence of a demand. The terms of the Rule have generally been followed by other appellate courts. *Lucking v. Delano*, 117 F.2d 159, 160 (6th Cir. 1941) ("Obviously the filing of the complaint cannot be regarded as a demand to sue, for by starting the action [plaintiffs] have usurped the field"); *Shlensky v. Dorsey*, 574 F.2d 131, 141-42 (3rd Cir. 1978) ("The contemplated showing of demand made upon the directors after the filing of the shareholders' derivative complaints could not have satisfied the demand requirements of the rule"); *Galef v. Alexander*, 615 F.2d 51, 59 (2d Cir. 1980) ("Rule 23.1 *** is essentially a requirement that a stockholder exhaust his intracorporate remedies before bringing a derivative action").

Though this court has not yet ruled squarely on the precise point, it has observed that the role of demand is to alert the director before suit is instituted. *In re Kauffman Mutual Fund Actions, supra*, 479 F.2d at 263, we said that "to be allowed, sua sponte, to place himself in charge without *first* affording the directors the opportunity to occupy their normal status, a stockholder must show that his case is exceptional," *i.e.* that demand is excused (emphasis added). The same postulate was expressed in *Heit v. Baird, supra*, 567 F.2d at 1162 (n.6): "The purpose of the demand requirement is, of course, to require resort to the body legally charged with conduct of the company's affairs *before* licensing suit in the company's name by persons not so charged" (emphasis added). Under this court's practice of vigorous enforcement of the Rule (*Heit v. Baird*, 567 F.2d at 1160; *see also In re Kauffman Mutual Fund Actions*, 479 F.2d at 263, 267), and of the generally "strict view" the court takes "of the requirement of prior demand" (*Untermeyer v. Fidelity Daily Income Trust*, 580 F.2d 22, 23 (1st Cir. 1978)), these statements should be, and are, now embodied in an explicit holding.

It makes no difference that in this instance the belated demand was made at the suggestion of the District Court. The

judge's colloquy with counsel shows that the court was simply making that suggestion, as the opinion below says, "in the hope that expensive and lengthy litigation could be avoided"; if the directors responded favorably to plaintiff, in whole or in part, that would clearly be the result. Grossman then made his demand voluntarily, with his expressed understanding "that the demand letter would not be deemed a waiver by any party of rights which it otherwise possessed." There was no direction by the court and no agreement that the late demand would rectify the initial failure to make a demand prior to suit.

IV

Because we hold that the suit must be dismissed because plaintiff did not make the necessary demand before suing, we refrain from considering the District Court's alternative holding that, in any event, defendants are entitled to judgment on the ground that their "alleged actions are protected by and comply with the requirements of the business judgment rules."

Affirmed.

Judgment of Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

No. 81-1348

STANLEY M. GROSSMAN,

Plaintiff, Appellant,

v.

EDWARD C. JOHNSON, II, *et al.*,

Defendants, Appellees.

JUDGMENT

Entered March 29, 1982

This cause came on to be heard on appeal from the United States District Court for the District of Massachusetts, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The judgment of the district court is affirmed.

By the Court:

DANA H. GALLUP,
Clerk.

By: /s/ FRANCIS P. SCIGLIANO
Chief Deputy Clerk

[cc: Messrs. Meyer, Dittmar, Farley, Facher and Kirby.]

Investment Company Act of 1940, §36(b)

INVESTMENT COMPANY ACT OF 1940,
Section 36(b), 15 U.S.C. § 80a-35(b)

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company,

shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78*o* of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Federal Rules of Civil Procedure 23.1

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share of membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

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CLERK

No. 81-2361

In the Supreme Court of the United States

OCTOBER TERM, 1981

STANLEY M. GROSSMAN,
PETITIONER,

v.

FIDELITY MUNICIPAL BOND FUND, INC. AND FIDELITY MANAGEMENT & RESEARCH CO.,
RESPONDENTS.

JOINT BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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No. 81-2361

In the Supreme Court of the United States

OCTOBER TERM, 1981

STANLEY M. GROSSMAN,
PETITIONER,

v.

FIDELITY MUNICIPAL BOND FUND, INC. AND FIDELITY MANAGEMENT & RESEARCH CO.,
RESPONDENTS.

JOINT BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

The petition for certiorari invites this Court to interpret the opinion of the Court of Appeals to say what it did not say, to find conflict where none exists and to decide issues which need not be reached.

Opinions Below.

The opinion of the Court of Appeals is reported at 674 F.2d 115. The opinion of the district court is reported at 89 F.R.D. 656. Both opinions are reproduced in the appendix to the petition.

Statute and Rule Involved.

This action involves the relationship between Rule 23.1 of the Federal Rules of Civil Procedure and section 36(b) of the Investment Company Act of 1940, as amended, 15 U.S.C. § 80a-35(b). Both are reproduced in the appendix to the petition.

Statement of the Case.

This petition arises out of a mutual fund shareholder's derivative suit brought under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1, *et seq.* (the "Act").

Petitioner is a shareholder of Fidelity Municipal Bond Fund, Inc. (the "Fund"), a registered investment company. The defendants included Fidelity Management & Research Co. ("FMR"), which is the Fund's investment adviser, FMR's parent corporation and eight of the Fund's directors. The Fund was a nominal defendant. Only the Fund and FMR, however, have been named respondents in the petition for a writ of certiorari.

The complaint raised two claims, but only one is relevant now. That claim charges that the Fund paid FMR an exces-

sive management fee in violation of section 36(b) of the Act, 15 U.S.C. § 80a-35(b). Under the advisory and service contract between FMR and the Fund, FMR received a management fee computed at the annual rate of 0.4% of the Fund's average daily net assets. The complaint claimed that this fee was excessive in light of the allegedly substantial growth of the Fund's assets, routine investment decisions involved in managing the Fund and poor Fund performance.

The complaint also alleged excuse from the director demand requirement of Fed.R.Civ.P. 23.1, and prior to commencing suit petitioner made no demand upon the Fund's directors.

Defendants filed motions to dismiss the complaint under Rule 23.1. Following hearing on the motions, petitioner filed an amended complaint supplementing the Rule 23.1 allegations, and defendants again moved to dismiss. At the next hearing, the district court indicated readiness to rule on the motions. However, the court inquired whether petitioner would make demand and instructed the directors to consider such a demand if it were made. The next day petitioner sent a letter to the board of directors reciting verbatim the substantive allegations of the amended complaint and demanding action.

After receiving petitioner's letter, the board of directors appointed a special committee consisting of two statutorily disinterested directors who were not defendants. The board delegated to the special committee full powers to take action on behalf of the Fund with respect to the demand.

Following an investigation conducted by specially retained outside counsel,* the special committee determined that it was

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* Pursuant to authorization to retain independent advisers of their choice, the special committee retained a former chairman of the Securities and Exchange Commission as special outside counsel. Special counsel and his staff conducted a three-month investigation entailing document review, interviews and legal research. Upon completion of his investigation, special

in the best interests of the Fund that the action be dismissed and instructed the Fund's counsel to take appropriate steps to do so. The Fund, joined by the other defendants, then moved to dismiss or for summary judgment.

Following further hearing, the district court dismissed the action; in the alternative, the court granted summary judgment in favor of defendants. The district court based its decision, alternatively, upon petitioner's failure to make demand prior to commencing suit and upon the good faith business judgment determination of the special committee following the belated demand.

Petitioner then appealed. On March 29, 1982 the Court of Appeals for the First Circuit affirmed the district court, "on the former ground, by-passing the latter." 674 F.2d at 118. With respect to the excessive management fee claim, the Court of Appeals rejected a variety of arguments raised by petitioner in an effort to demonstrate that Rule 23.1 is wholly inapplicable to shareholder suits under section 36(b). *Id.* at 118-23. The Court of Appeals concluded that "there is no persuasive indication that, in adopting section 36(b), Congress wished to repeal or limit the demand provision of Rule 23.1 which has long been a general part of our federal law practice and procedure, governing almost all derivative actions in federal courts." *Id.* at 122.

Having found Rule 23.1 applicable to petitioner's suit, the Court of Appeals next concluded that demand was not excused.

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counsel submitted a 230-page report to the committee. The report set forth detailed factual findings, legal conclusions and recommendations for action. With respect to the excessive fee claim, special counsel concluded that the Fund's directors had been "fully informed" by FMR regarding facts necessary to their periodic decisions to approve the Fund's management fee; that they had "independently evaluated" all relevant information; and that they had engaged in "meaningful negotiations" with FMR. Special counsel also concluded that the fee had been "fair" and "not excessive." Special counsel advised the committee to seek to dismiss petitioner's suit.

Id. at 123-25. Finally, the Court of Appeals held that petitioner's post-litigation demand did not cure his failure to make demand before commencing suit and that therefore the action had been properly dismissed. *Id.* at 125-26.

The Court of Appeals concluded its opinion by emphasizing that it had refrained from considering whether defendants were entitled to judgment by virtue of the business judgment decision of the directors following petitioner's belated demand. *Id.* at 126.

Reasons for Denying the Writ.

A. The Decision of the Court of Appeals does Not Conflict with Decisions of This Court.

In asserting that the decision of the Court of Appeals conflicts with decisions of this Court, petitioner urges the Court to find conflict where there is none and to rule on issues which need not be decided.

1. *There is No Conflict With* Burks *v.* Lasker.

Petitioner argues that the decision of the Court of Appeals conflicts with an observation regarding directorial termination of suit made by this Court in *Burks* v. *Lasker*, 441 U.S. 471 (1979). (Petition pp. 7-8). But the asserted conflict is imaginary, and the issue is in any event inadequately presented here.

Burks involved judgment entered against a mutual fund shareholder in a derivative suit under section 13(a)(3) and former section 36 of the Act and under section 206 of the Investment Advisers Act. During pendency of the action, the

disinterested minority of fund directors had investigated the claims and concluded that further prosecution of suit was against the best interests of the fund. Based upon this determination, the fund successfully moved for summary judgment. 441 U.S. at 473-75. The question in *Burks* was whether the disinterested directors had the power to terminate the derivative suit in the exercise of their business judgment, 441 U.S. at 473, and this Court held that "federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the [Investment Company and Investment Advisers Acts]." *Id.* at 486.

During the course of considering the issue before it, the Court observed that:

> when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), 84 Stat. 1428, 15 U.S.C. § 80a-35(b)(2), added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

Id. at 484.

Far from conflicting with *Burks*, the Court of Appeals expressly avoided deciding whether the Fund's disinterested directors could terminate petitioner's section 36(b) suit through the exercise of business judgment. The Court of Appeals declined to affirm the district court on this basis and bypassed decision on this ground. 674 F.2d at 118, 126. The court did so in an explicit effort to resolve the case on narrower grounds and to avoid any conflict with *Burks*. *Id.* at 121. Indeed, in reaching its decision, the Court of Appeals assumed "*arguendo*" that this Court's dictum in *Burks* precluded the

Fund's disinterested directors from terminating petitioner's section 36(b) suit. *Id.* Given the pains taken by the Court of Appeals to avoid decision on grounds which may be affected by *Burks*, there can be no conflict for this Court to resolve. *See* Sup. Ct. R. 17.1(c).

Burks itself, for that matter, did not involve application of Rule 23.1. The Court's opinion does not mention, let alone analyze, the demand requirements of Rule 23.1; indeed, the district court had previously indicated that the issue of demand under Rule 23.1 "is not presented in this case." *Lasker* v. *Burks*, 404 F.Supp. 1172, 1178 (S.D.N.Y. 1975). Nor did *Burks* even involve a claim under section 36(b). In its opinion this Court did not address the interplay of the statute and the rule and indicated no intention to provide guidance in applying them together. The focus in *Burks* was upon the power of directors to terminate a derivative suit already properly commenced. 441 U.S. at 486. Construction and application of Rule 23.1, which sets conditions precedent to derivative suit, are matters to which the Court did not speak.

Moreover, this Court is unlikely to reach the issue of asserted conflict should certiorari be granted. The Court of Appeals decided the case on narrow grounds. The court concluded that the demand requirement of Rule 23.1 serves substantial purposes unaffected by a limitation on the power of directors to terminate derivative claims. 674 F.2d at 121. Only if the grounds of the lower court's decision are insufficient would this Court need to address the grounds by-passed below. Yet the reasoning of the Court of Appeals was sound. Demand serves to exhaust intracorporate remedies prior to suit. *Galef* v. *Alexander*, 615 F.2d 51, 59 (2d Cir. 1980); *Lucking* v. *Delano*, 117 F.2d 159, 160 (6th Cir. 1941); 3B *Moore's Federal Practice*, ¶ 23.1.16[1] at 23.1-49 (2d ed. 1982). Negotiation, arbitration and unilateral directorial action are available to

redress mutual fund shareholder grievance. *See Markowitz* v. *Brody*, 90 F.R.D. 542, 560-61 (S.D.N.Y. 1981); *Weiss* v. *Temporary Investment Fund, Inc.*, 516 F.Supp. 665, 669-70 (D. Del. 1981); *cf. Boyko* v. *Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y. 1976). At the very least, as the Court of Appeals noted, directorial response to demand might be a matter of considerable significance to a district court when deciding the merits of a section 36(b) claim. In this regard it should be noted that the provisions of subparagraph (b)(2) require directorial approval to be given "such consideration by the court as is appropriate under all the circumstances." 674 F.2d at 121.

Finally, since the Court of Appeals avoided decision on the question of directorial termination of suit, it articulated no analysis of the relevant issues of law. Nor for that matter is there a body of law developed by other courts of appeals on the subject. *See Vasquez* v. *United States*, 50 U.S.L.W. 3343 (November 2, 1981). The Court of Appeals also declined analysis of the facts and circumstances of the case relevant to such an exercise of directorial power. The case is ill-suited, in short, for dispositive decision by this Court because the question was not thoroughly assayed below. *Cf. Maryland* v. *Baltimore Radio Show, Inc.*, 338 U.S. 912, 918 (1950) (opinion of Frankfurter, J.).

2. *There is No Conflict with This Court's Implied Right of Action Cases.*

Petitioner argues that certiorari should be granted because the decision of the Court of Appeals "implied a right of action in contravention of standards" enunciated by this Court. (Petition p. 9.) But this asserted conflict is similarly imaginary, and the issue is peripheral to the case.

In the course of its opinion, the Court of Appeals concluded that a mutual fund has a right of action under section 36(b). The court expressed this view in response to petitioner's argument that a mutual fund itself has no right of action under the statute and that, because it has none, Rule 23.1 does not apply. 674 F.2d at 120. Petitioner argues, in short, that a determined directorate cannot sue; only a shareholder can. But since Congress clearly contemplated a damage remedy for the benefit of the mutual fund, the argument makes no sense. In fact, the Court of Appeals discussed the point in a section of its opinion addressed to a series of petitioner's arguments which the court believed "to have little merit." *Id.* The court disposed of the argument by noting its disbelief that a "new and independent" board of directors would be "precluded from suing" under section 36(b); by concluding that, in providing for suit by a shareholder "on behalf of" an investment company, it was "unnecessary" for Congress to say "with particularity" that the company could bring suit itself; and by observing that in all other respects petitioner had proceeded on the "correct assumption that this is a derivative suit to enforce rights the Fund could itself enforce. . . ." *Id.*

The conclusion of the Court of Appeals does not conflict with this Court's recent implied right of action cases. There is no decision of this Court holding that an investment company may not sue under section 36(b); hence, there is no direct conflict to resolve. *See* Sup. Ct. R. 17.1(c).

Nor is there any conflict with the principles of statutory construction announced by this Court's recent decisions. The issue, of course, is one of Congressional intent. *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 15-16 (1979). Background, language, purpose and legislative history bear on the question. Considering all, the Court of Appeals was clearly correct.

"In determining whether a private cause of action is implicit in a federal statutory scheme . . ., the initial focus must be on the state of the law at the time the legislation was enacted." *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 50 U.S.L.W. 4457, 4464 (May 3, 1982). At the time of enactment of section 36(b), implied rights of action under the Act had been recognized by the federal courts, and they had been regarded as derivative claims. *See, e.g., Levitt* v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Chabot* v. *Empire Trust Company*, 301 F.2d 458 (2d Cir. 1962); *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961). During its passage through hearings, section 36(b) was supported by reference to these decisions and by discussion of the salutary effect of "derivative actions" under the federal securities laws. *See, e.g.*, Hearings before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce on H.R. 11995, S.2224, H.R. 13754, and H.R. 14737, 91st Cong. 1st Sess. 202, 699, 796, 881. A derivative claim, of course, is a claim of the mutual fund. It must be enforceable, as well, by the fund itself.

The language of section 36(b) bears this out, as the Court of Appeals noted. 674 F.2d at 120. Under the terms of the statute, petitioner has sued "on behalf of" the Fund, for alleged breach of fiduciary duty with respect to compensation "paid by" the Fund, seeking damages limited to the amount of compensation "received from" the Fund. Here "the statutory language itself fairly implies a right" of action on the part of the Fund itself. *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, *supra*, 444 U.S. at 18.

The "structure of the statute," *id.*, likewise supports the Fund's right to sue. It is apparent that section 36(b) was "intended to benefit" the Fund, *id.* at 17, for the statute creates federal rights "in favor of" the Fund. *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 569 (1979). The Fund is "one of the

class for whose *especial* benefit the statute was enacted." *Cort* v. *Ash*, 422 U.S. 66, 78 (1975).

Petitioner's argument to the contrary, for that matter, derives not from decisions of this Court so much as from an unsupported assumption. Petitioner asserts that mutual fund directors cannot sue under section 36(b) "since the basic motivation for that provision was a recognition that the directors of a mutual fund could not be trusted to make an objective decision concerning fairness of compensation." (Petition p. 10; *id.* p. 8.) Nothing, however, could be wider from the mark. Under the overall scheme of the Act, disinterested directors serve as "watchdogs" of the mutual fund. *Burks* v. *Lasker*, *supra*, 441 U.S. at 484. The 1970 amendments to the Act, which added section 36(b), were designed to enhance, not deprecate, this role of the disinterested directorate. *See id.* at 482-84. As for section 36(b) itself, the Senate Committee reported: "This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees." S. Rep. No. 91-184, 91st Cong. 2d Sess., *reprinted in* 1970 U.S. Code Cong. & Admin. News 4897, 4902. The committee admonished that "the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. . . . The section is not intended to shift the responsibility for managing an investment company in the best interests of its shareholders from the directors of such company to the judiciary." *Id.* at 4903.

Petitioner's argument is, in effect, that Congress intended that a federal court should be obliged to dismiss suit initiated by mutual fund directors if they found past fees to have been excessive and sought judicial relief themselves. In light of the central role of the disinterested directorate, this result is inconceivable.

Although petitioner cites *Boyko* v. *Reserve Fund, Inc.*, 68 F.R.D. 692, 695-96 (S.D.N.Y. 1975), and *Blatt* v. *Dean Witter Reynolds Intercapital, Inc.*, 528 F.Supp. 1152, 1155 (S.D. N.Y. 1982), to support his position, these decisions suffer the same flaw in fundamental premise as does petitioner's argument. Other district courts have directly disagreed. Within the Southern District of New York itself, for example, both *Boyko* and *Blatt* have been rejected for having "ignored the congressional imperative for independent management of money market funds and mistakenly presumed . . . that the directors of an investment company are uniformly antagonistic to 'an action against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation.'" *Fox* v. *Reich & Tang, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,612 at 93,023 (S.D.N.Y. April 2, 1982).

Finally, it is not at all clear that determination of a mutual fund's right to sue under section 36(b) is necessary to decision as to the applicability of Rule 23.1. The Court of Appeals reasoned that demand serves important purposes unrelated to any directorial decision regarding suit. A right might be enforced or a groundless claim abandoned without litigation, and, in any event, a record of directorial deliberation would be made. 674 F.2d at 121. Other courts have agreed. *See Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 91 F.R.D. 524, 526 (S.D.N.Y. 1981); *Markowitz* v. *Brody, supra*, 90 F.R.D. at 560-61.

Four district courts, other than the district court below, have held Rule 23.1 applicable to a section 36(b) suit. But decision has not necessarily turned on the fund's right of action. One court expressly ruled that a fund itself may sue. *Markowitz* v. *Brody, supra*, 90 F.R.D. at 557 n.12. One avoided the point by finding other purposes served. *Gartenberg* v. *Merrill Lynch Asset Management, Inc., supra*, 91 F.R.D. at 526. Two ruled without reaching the issue. *Fox* v. *Reich & Tang, Inc.*,

supra; *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*. Two district courts, on the other hand, have found the demand rule inapplicable. *Boyko* v. *Reserve Fund, Inc.*, *supra*; *Blatt* v. *Dean Witter*, *supra*. Although both voiced the view that a mutual fund itself cannot sue under section 36(b), one curiously found demand under Rule 23.1 to be excused, for futility, only if there is an interested member on the board of directors. Otherwise the court's ruling was "not to be construed as a holding that Rule 23.1 has been in any way abrogated by Section 36(b)." *Boyko* v. *Reserve Fund, Inc.*, *supra*, 68 F.R.D. at 696.

If there is inconsistency among the district courts, the task of resolution belongs in the first instance to the courts of appeals. Perhaps then uniformity, or at least clarity of the issues, will emerge. Mr. Justice Frankfurter's observation is surely apt: "It may be desirable to have different aspects of an issue further illumined by the lower courts. Wise adjudication has its own time for ripening." *Maryland* v. *Baltimore Radio Show, Inc.*, *supra*, 338 U.S. at 918.

B. The Decision of the Court of Appeals does Not Conflict with the Decision of the Court of Appeals for the Third Circuit in *Lewis* v. *Curtis*.

Petitioner claims that the decision of the Court of Appeals conflicts with the decision of the Court of Appeals for the Third Circuit in *Lewis* v. *Curtis*, 671 F.2d 779 (3d Cir. 1982). But, on facts as on law, these decisions have little in common.

Lewis is a case growing out of a shareholder challenge to his corporation's settlement of a proxy contest. Plaintiff claimed that the settlement constituted a waste and spoliation of corporate assets. Prior to filing his complaint plaintiff made no demand on the corporation's directors, and afterward he sought

to amend in order to plead particulars showing excuse. The district court denied leave to amend and dismissed the complaint, but the Third Circuit reversed, holding the denial of leave to amend to be an abuse of the district court's discretion.

The issue for decision in *Lewis* was whether the amended complaint pleaded Rule 23.1 excuse with requisite particularity. *Id.* at 783-84. The Court of Appeals found that the amended complaint contained "detailed allegations concerning the financial interests" of the directors in the challenged transaction and showed that the transaction was part of a "larger scheme" by these directors to "retain control" of the corporation. *Id.* at 784. In the course of its analysis, the Court of Appeals reasoned that it should apply the same standard of "interestedness" in reviewing the demand requirement in the first instance as it would use in reviewing directorial rejection of demand later. *Id.* at 785-86. Given directorial financial interest in the challenged transaction, the court concluded that any decision in response to demand would be inconsistent with the directors' fiduciary duty to render business judgments free from bias. *Id.* at 786. Upon plaintiff's allegations, "the directors to be sued would control the response to any demand." *Id.* Due to their financial interest, therefore, demand on the directors was found to be futile. *Id.* at 786-87.

Simple summary of the case reveals that the court in *Lewis* decided different issues of law upon different circumstances of fact than were presented to the Court of Appeals below. The issue in *Lewis* was Rule 23.1 excuse; the issue here is Rule 23.1 applicability. The facts in *Lewis* involved financial self-interest; the facts here reveal a disinterested directorate. In *Lewis* the Third Circuit concluded that directorial interest made demand futile because no directorial action in response to demand could be free from bias; no directorial action, in short, could be proper. Here, on the other hand, under an interpretation of statute which the Court of Appeals assumed *arguendo*,

the range of directorial response to demand may be limited, but it is not wholly foreclosed. In *Lewis* the directors were defendants; hence they were disabled from taking any proper action. Here, by contrast, the directors stood ready to act and had options available. Under these circumstances there can be no square and irreconcilable conflict to justify review. *See, e.g., Bailey* v. *Weinberger*, 419 U.S. 953 (1974) (dissenting opinion).

Indeed, the Court of Appeals below and the Third Circuit in *Lewis* do not even conflict in "approach," as petitioner asserts. (Petition p. 12.) Both courts in fact considered the scope of permissible directorial response to demand before determining whether derivative suit may be maintained in the absence of demand. The results were different, to be sure, but that was because in one case the directors could act, while in the other they could do nothing at all.

The decision below neither conflicts with *Lewis* nor decides the same question. There is nothing in either case to suggest that the Third Circuit would have reached a different result here than did the First.

Conclusion.

For the foregoing reasons the petition for a writ of certiorari should be denied.

Respectfully submitted,

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REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

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REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

POINT I

The Court of Appeals Decision Conflicts with this Court's Decision in *Burks* v. *Lasker*

The principal argument advanced by the respondents is that the Court of Appeals decision does not conflict with this Court's decision in *Burks* v. *Lasker,* 441 U.S. 471 (1979), because *Burks* dealt with directorial termination of suit whereas the Court of Appeals decision dealt with the necessity for demand upon directors.

The argument misses the point. In *Burks* this court correctly stated that, by enacting § 36(b), Congress prevented board action from cutting off derivative suits; *id.* at 484. The cutting off of derivative suits applies equally to a decision not to sue before litigation is commenced as well as a decision to terminate an action already commenced. Indeed, this Court noted in *Burks* that a directorial decision not to sue—

in situations not covered by § 36(b)—is consistent with allowing the independent directors to terminate suit; *id.* at 485.

The purported rationale enunciated by the Court of Appeals for requiring a pre-complaint demand is that it can serve the function of informing the court of the directors' knowledgeable viewpoint on the merits of the litigation; 674 F.2d at 121. Certainly, the views of the directors should be considered on the merits; § 36(b)(2) so directs. But it is neither necessary nor appropriate to invoke Rule 23.1 to apprise the court of their attitude.*

Three other circuits—the Second, Fifth and Ninth Circuits—have held that Congressional creation of an action which can be instituted by any security holder, as under § 36(b), obviates the requirements of Rule 23.1 so that suit may be brought by a shareholder "without qualification"; *Blau* v. *Mission Corp.*, 212 F.2d 77, 79 (2d Cir. 1954), *cert. denied*, 347 U.S. 1016 (1954); and "not subject to the procedural requirements of the Rule [23.1]"; *Dottenheim* v. *Murchison*, 227 F.2d 737, 740 (5th Cir. 1955), *cert. denied*, 351 U.S. 919; *Pellegrino* v. *Nesbit*, 203 F.2d 463, 466 (9th Cir. 1953).

The aforesaid cases all dealt with § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b). In *Burks* this Court analogized the inability of the directors to cut off a derivative suit brought under § 36(b) to the right of a shareholder to sue under § 16(b) of the Exchange Act "notwithstanding the decision of the board of directors not to sue." 441 U.S. at 484 n. 13. Thus, the conflict of the decision of the Court of Appeals in the instant case with this Court's decision in *Burks* v. *Lasker*—as well as with the decisions of the Second, Fifth and Ninth Circuits cited above—could not be more direct.

* Moreover, in the instant case, the post-complaint demand served to advise the court of the directors' position to the same extent that a pre-complaint demand would have done.

POINT II

The Court of Appeals Decision Conflicts With This Court's Holdings in Implied Right of Action Cases

The statute creates an express right of action by the Securities and Exchange Commission and by any security holder of an investment company. "In view of these elaborate enforcement provisions it cannot be assumed that Congress intended to authorize by implication additional judicial remedies". *Middlesex County Sewerage Authority* v. *National Sea Clammers Association*, 101 S.Ct. 2615, 2623 (1981). Nevertheless, respondents seek to imply such a right of action on behalf of the Fund from those provisions of the Investment Company Act designed to bolster the role of independent directors (Resp. Br., p. 11).

To be sure, Congress in the 1970 amendments to the Investment Company Act included provisions imposing stringent duties upon disinterested directors, as well as interested directors, of investment companies. And Congress believed that this would strengthen the role of disinterested directors. But there is no inconsistency between those provisions and the provisions enabling security holders to sue directly. Indeed, they are complementary means for remedying the evil which Congress was attempting to eliminate: namely, the charging of excessive advisory fees by investment advisors:

> "The unaffiliated directors, as the only potentially disinterested persons in the management of most investment companies, can and should play an active role in representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to

the protection of public shareholders. *But even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation.*" (House Rep. No. 2337, 89th Cong., 2d Session, p. 148 (1966)). (emphasis supplied)

In order to provide such a check, Congress authorized suits by the SEC and by security holders, but not by investment company directors. As the court noted in *Boyko* v. *The Reserve Fund, Inc.*, 68 F.R.D. 692, 695 (S.D.N.Y. 1975), the decision not to confer the right to sue upon the corporation was not an oversight. It resulted from reluctance to vest control of advisory fee litigation in the directors, who were deemed to be ineffective checks upon management compensation. Since they can not sue, no demand upon them is required.

CONCLUSION

For the foregoing reasons the petition for writ of certiorari should be granted.

Respectfully submitted,

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